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Investment Institute

Chart of the Week

Weekly market analysis on key market indexes | February 21, 2024

The role of diversification amid wide performance gaps

Asset group	Global fixed income	U.S. equities	DM equities	EM equities	Commodities	Hedge funds*
Top performer	High Yield Fixed Income: 13.4%	U.S. Large Cap Growth Equities: 42.7%	MSCI Italy Index: 38.8%	MSCI Hungary Index: 50.9%	Bloomberg Precious Metals Subindex: 9.6%	HFRI Event Driven Activist Index: 18.1%
Index total return	Bloomberg Multiverse Index: 6.0%	Russell 3000® Index: 26.0%	MSCI World Index: 24.4%	MSCI Emerging Markets Index: 10.3%	Bloomberg Commodity Index: -7.9%	HFRI Fund Weighted Composite Index: 8.1%
Bottom performer	DM ex-U.S. Fixed Income: 4.0%	U.S. Large Cap Value Equities: 11.5%	MSCI Hong Kong Index: -14.8%	MSCI China Index: -11.0%	Bloomberg Energy Subindex: -21.6%	HFRI Macro Systematic Diversified Index: -3.8%
Difference between top and bottom performer	9.5%	31.2%	53.6%	61.9%	31.3%	21.8%

Sources: Bloomberg and Wells Fargo Investment Institute. 2023 calendar year total returns as of December 31, 2023. DM = developed market. EM = emerging market. High Yield Fixed Income = Bloomberg U.S. Corporate High Yield Index. DM ex-U.S. Fixed Income = JPM GBI Global ex-U.S. U.S. Large Cap Growth Equities = Russell 1000® Growth Index. U.S. Large Cap Value Equities = Russell 1000® Value Index. Data from January 1, 2008 through December 31, 2023. *Alternative investments, such as hedge funds, private equity and private real estate funds are not appropriate for all investors and are only open to "accredited" or "qualified" investors within the meaning of U.S. securities laws. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**

Narrow market breadth led to wide divergences between top and bottom performers

Narrow market breadth was not only an equities story last year — the divergence in the top and bottom performers across asset groups and geographical regions was wide in 2023, shown in the table above. Having exposure to the worst-performing asset would have drastically reduced performance, while exposure to the highest-performing asset would have proved very fruitful. For example, emerging market (EM) equities were up 10.3% in 2023. The top-performing EM was Hungary, up nearly 51%, while China declined 11%, leaving a 62% dispersion between the top and bottom performer.

It is not apparent ahead of time exactly which asset class, asset style, or country will be the top or bottom performer. But when dispersion is so great, maintaining a strategic allocation and tactically tilting toward those asset classes or sectors that appear to have potential opportunities for gains could be a good way to take advantage of the variation. Meanwhile, having broader exposure to various assets reduces the risk of choosing only the worst-performing assets in a concentrated portfolio, which could be very costly.

What it may mean for investors

As the old adage goes, "don't put all your eggs in one basket". Having exposure to only one type of equity, fixed-income instrument, or commodity can leave a portfolio vulnerable to being left behind once leadership within an asset class inevitably changes. Instead of concentrating portfolios in a handful of assets, we believe making tactical (6 – 18 month) adjustments of exposure to certain sectors of the market based on the market and economic environment is a good way to take advantage of current trends. For investors with a longer-term focus, maintaining broad-based exposure within asset classes is prudent to ensure exposure to assets that may take leadership over shorter periods.

Veronica Willis, *Global Investment Strategist*

Excerpted from *Investment Strategy* (February 20)

Risk Considerations

Asset allocation and diversification do not guarantee investment returns or eliminate risk of loss including in a declining market.

Forecasts and targets are based on certain assumptions and on views of market and economic conditions which are subject to change.

Each asset class has its own risk and return characteristics. The level of risk associated with a particular investment or asset class generally correlates with the level of return the investment or asset class might achieve. **Stock markets**, especially foreign markets, are volatile. Stock values may fluctuate in response to general economic and market conditions, the prospects of individual companies, and industry sectors. **Foreign investing** has additional risks including those associated with currency fluctuation, political and economic instability, and different accounting standards. These risks are heightened in emerging markets. **Growth stocks** may be more volatile than other stocks and there is no guarantee growth will be realized. There are no guarantees that **value stocks** will increase in value or that their intrinsic values will eventually be recognized by the overall market. Both growth and value types of investing tend to shift in and out of favor. **Bonds** are subject to market, interest rate, price, credit/default, liquidity, inflation and other risks. Prices tend to be inversely affected by changes in interest rates. **High yield (junk) bonds** have lower credit ratings and are subject to greater risk of default and greater principal risk. The **commodities** markets are considered speculative, carry substantial risks, and have experienced periods of extreme volatility. Investing in a volatile and uncertain commodities market may cause a portfolio to rapidly increase or decrease in value which may result in greater share price volatility.

Alternative investments carry specific investor qualifications which can include high income and net-worth requirements as well as relatively high investment minimums. They are complex investment vehicles which generally have high costs and substantial risks. The high expenses often associated with these investments must be offset by trading profits and other income. They tend to be more volatile than other types of investments and present an increased risk of investment loss. There may also be a lack of transparency as to the underlying assets. Other risks may apply as well, depending on the specific investment product.

Hedge fund strategies, such as Equity Hedge, Event Driven, Macro and Relative Value, may expose investors to the risks associated with the use of short selling, leverage, derivatives and arbitrage methodologies. Short sales involve leverage and theoretically unlimited loss potential since the market price of securities sold short may continuously increase. The use of leverage in a portfolio varies by strategy. Leverage can significantly increase return potential but create greater risk of loss. Derivatives generally have implied leverage which can magnify volatility and may entail other risks such as market, interest rate, credit, counterparty and management risks. Arbitrage strategies expose a fund to the risk that the anticipated arbitrage opportunities will not develop as anticipated, resulting in potentially reduced returns or losses to the fund.

Definitions

Bloomberg Commodity Index is comprised of 22 exchange-traded futures on physical commodities and represents 20 commodities weighted to account for economic significance and market liquidity.

Bloomberg Energy Subindex is a commodity group subindex of the Bloomberg CITR. The index is composed of futures contracts on crude oil, heating oil, unleaded gasoline and natural gas. It reflects the return on fully collateralized futures positions and is quoted in USD.

Bloomberg Multiverse Index provides a broad-based measure of the global fixed-income bond market. The index represents the union of the Global Aggregate Index and the Global High-Yield Index and captures investment grade and high yield securities in all eligible currencies.

Bloomberg Precious Metals Subindex is a commodity group subindex of the Bloomberg CITR. The index is composed of futures contracts on gold and silver. It reflects the return on fully collateralized futures positions and is quoted in USD.

Bloomberg U.S. Corporate High Yield Bond Index covers the U.S. dollar-denominated, non-investment grade, fixed-rate, taxable corporate bond market. J.P. Morgan EMBI Global (USD) is a U.S. dollar-denominated, investible, market cap-weighted index representing a broad universe of emerging market sovereign and quasi-sovereign debt.

HFRI Event Driven Activist Index: Strategies may obtain or attempt to obtain representation on the company's board of directors in an effort to impact the firm's policies or strategic direction and in some cases may advocate activities such as division or asset sales, partial or complete corporate divestiture, dividends or share buybacks, and changes in management. Strategies employ an investment process primarily focused on opportunities in equity and equity-related instruments of companies that are currently or prospectively engaged in a corporate transaction, security issuance/repurchase, asset sales, division spin-off or other catalyst-oriented situation. These involve both announced transactions and situations in which no formal announcement is expected to occur. Activist strategies would expect to have greater than 50 percent of the portfolio in activist positions, as described.

HFRI Fund Weighted Composite Index is a global, equal-weighted index of over 2000 single-manager funds that report to HFR Database. Constituent funds report monthly net-of-all-fees performance in U.S. dollars and have a minimum of $50 Million under management or a 12-month track record of active performance. The HFRI Fund Weighted Composite Index does not include Funds of Hedge Funds.

HFRI Macro Systematic Diversified Index: Diversified strategies employing mathematical, algorithmic and technical models, with little or no influence of individuals over the portfolio positioning. Strategies are designed to identify opportunities in markets exhibiting trending or momentum characteristics across individual instruments or asset classes. Strategies typically employ quantitative processes which focus on statistically robust or technical patterns in the return series of the asset, and they typically focus on highly liquid instruments and maintain shorter holding periods than either discretionary or mean-reverting strategies. Although some strategies seek to employ counter-trend models, strategies benefit most from an environment characterized by persistent, discernible trending behavior. Typically have no greater than 35 percent of portfolio in either dedicated currency or commodity exposures over a given market cycle.

J.P. Morgan Government Bond Index (GBI) Global ex-U.S. (Unhedged) in USD is an unmanaged index market representative of the total return performance in U.S. dollars on an unhedged basis of major non-U.S. bond markets.

MSCI China Index captures large and mid-cap representation across China H shares, B shares, Red Chips and P Chips. With 140 constituents, the index covers about 85% of the China equity universe.

MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets.

MSCI Hong Kong Index is designed to measure the performance of the large and mid cap segments of the Hong Kong market.

MSCI Hungary Index is designed to measure the performance of the large and mid cap segments of the Hungarian market.

MSCI Italy Index is designed to measure the performance of the large and mid cap segments of the Italian market.

MSCI World Index captures large and mid-cap representation across 23 Developed Markets (DM) countries, including Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Hong Kong, Ireland, Israel, Italy, Japan, Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, the U.K., and the U.S.

Russell 1000® Growth Index measures the performance of the large-cap growth segment of the U.S. equity universe. It includes those Russell 1000 companies with higher price-to-book ratios and higher forecasted growth values.

Russell 1000® Value Index measures the performance of the large-cap value segment of the U.S. equity universe. It includes those Russell 1000 companies with lower price-to-book ratios and lower expected growth values.

Russell 1000® Index measures the performance of the 1,000 largest companies in the Russell 3000 Index, which represents approximately 90% of the total market capitalization of the Russell 3000 Index.

Russell 3000® Index is composed of 3000 large U.S. companies, as determined by market capitalization. This portfolio of Securities represents approximately 98% of the investable U.S. equity market. The Russell 3000 Index is comprised of stocks within the Russell 1000 and the Russell 2000 Indices.

S&P 500 Index is a market capitalization-weighted index composed of 500 stocks generally considered representative of the U.S. stock market.

S&P 500 Equal Weight Index (EWI) is the equal-weight version of the widely-used S&P 500. The index includes the same constituents as the capitalization weighted S&P 500, but each company in the S&P 500 EWI is allocated a fixed weight - or 0.2% of the index total at each quarterly rebalance.

An index is unmanaged and not available for direct investment.

Note: HFRI Indices have limitations (some of which are typical of other widely used indices). These limitations include survivorship bias (the returns of the indices may not be representative of all the hedge funds in the universe because of the tendency of lower performing funds to leave the index); heterogeneity (not all hedge funds are alike or comparable to one another, and the index may not accurately reflect the performance of a described style); and limited data (many hedge funds do not report to indices, and, therefore, the index may omit funds, the inclusion of which might significantly affect the performance shown. The HFRI Indices are based on information self-reported by hedge fund managers that decide on their own, at any time, whether or not they want to provide, or continue to provide, information to HFR Asset Management, L.L.C. Results for funds that go out of business are included in the index until the date that they cease operations. Therefore, these indices may not be complete or accurate representations of the hedge fund universe, and may be biased in several ways. Returns of the underlying hedge funds are net of fees and are denominated in USD.

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